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Coalition of the Spending (New Government First Steps)

Krassen Stanchev

The constellation after elections

In the previous issue of this bulletin I shared some expectations the proved wrong.

Immediately after elections I expected a **tacit** coalition led by Socialists (BSP). Now there is an **open** coalition in place, consisting of BSP, the King's party (National Movement Simeon the Second, NMSS) and the Movement for Rights and Freedoms (MRF) and sealed by a coalition agreement. It took six-seven weeks of tricky talks to reach an agreement to form an executive with MRF mandate after two consecutive failures of BSP and NMSS to recruit sufficient support.¹ The outcome, however, is a legislative majority of 2/3 of the seats, sufficient to amend the constitution if needed.²

Also, I expected a slow down in GDP growth. For the time being, however, all data demonstrate a rate of plus 6% y/y in the second quarter. There was a delay in privatization but elections had an impact of Christmas in the summer, stepped up public procurement and increased investment by private sector on projects launched last year and in the first

quarter. The take off of the tourist season (May and June) was strong and by end August the number of visitors went up by 18% compared to the same period last year. Central bank restriction on credit (effective since April) and increased oil prices should have a delayed and somewhat insignificant impact this year. Consumption and investment are still strong.

The economic growth and other factors resulted, by the end of the second quarter in a budget surplus of 2.65%.

The composition

There was no such broad ruling coalition in the last fifteen years. In general coalition has been difficult uniting either center-right (1991-1992, 1997-2001, 2001-2005) or center left (1994-1997) like minded political groupings. Only the Movement for Rights and Freedoms (MRF, the party Bulgaria Muslims vote for) had demonstrated inclinations to join either center when necessary. MRF is a member of the so-called Liberal International, the global group of centrist and reformist politicians and parties but its political leaning in Bulgaria context is more to the left. Now the government is built on the MRF mandate. In the period between late June – end August, all other parties had failed to set a workable executive. The coalition members are MRF, the ex-communist Bulgaria Socialist Party (BSP) and the National Movement Simeon the Second (NMSS, the ex-king-PM's party, also a member of the Liberal International).

The only past precedent of a similar left-left coalition was the Fatherland Front of September 1944, which was established with the help of the

¹ The constitution gives an opportunity to make three attempts to form a cabinet after a change in the government.

² It might be the case with reforming judiciary to meet EU accession requirements, particularly in terms of abolishing the immunity of magistrates and prosecutors.

Soviet army, extinguished the non-cooperative opposition and expelled than the boy-king Simeon. Foreigners would not know and Bulgarians could have already forgotten that the Fatherland Front was the constitutional chirm of the Communist rule until 10 November 1989 and the formal government change after the first multi-party elections of June 1990.

This historic connotation is not suggesting any peculiar treat for the country in the coming years. It simply reveals a reputation shortage of the incumbent government, which could play a creative role: presumably, the coalition member would undertake no policy that could bring about restoration of communist political habits or signs of it. Although, as we will see below, the leftist agenda is already dominating initiatives in the economic area.

The composition of government offices has been agreed under the following scheme of distribution of the seats in the executive: **8(BSP): 5(NMSS): 3(MRF)**, and the scheme penetrates all layers of government, including appointees on district and central representatives on local level.

The overall division of labor is the following:

- BSP, securing the prime-ministership for its leader, Mr. Stanishev, controls the most spending and key economic ministries, i.e. those of foreign affairs, the interior, economy and energy (united in one), transport, labor, healthcare, culture and housing;
- NMSS, controls most of the bureaucracy via the ministries of state administration, justice, defense, EU integration;
- MRF controls the least accountable spending of EU funds and subsidies via the ministries of agriculture, environment and emergency situations – one of the best funded bodies with loose pockets.

The minister of finance, Mr. Plamen Oresharski, is independent. He is a former deputy minister of finance in the Kostov cabinet of the United Democratic Forces (UDF, 1997-2001) and was responsible for managing the government debt. His only political backing is Mr. Stanishev; the finance minister reports directly to him.

Above the coalition is the Coalition Council, informal Polit-Bureau-like structure, where party leaders deliberate key policies and personnel issues. Taking into account this background, I

can name the ruling structure and “Coalition of the Spending”.

What is the government up to?

The PM and the coalition’s statement of intent claim this government is one of “European Integration, Economic Growth and Social Responsibility”.

There is little imagination and room to maneuver in the policy area of EU accession. (see the special section on EU Bulgaria relations.) The economic growth is a non-trivial task when a country runs, as it is the case of Bulgaria in 2005, at 5.5-6% annual real GDP rate, has a generous (at 16% of GDP budget expenditures) social welfare, the government spends 42-43% of GDP, the folks are old (the dependency ratio is 1:1), but nobody intends to reduce the fiscal burden.

The first three month of government operation is characteristic with the following:

- The new coalition inherited a luxurious budget surplus of 2.7% of GDP by the third quarter of the year; half of it was agreed with IMF to be saved as surplus by the year end. It is not yet clear (the report on fiscal performance is available at the day of this publication), but it seems that the line ministries have spent more than agreed upon. Last week of October the IMF mission left without approval of the next year fiscal outlook.³ Part of the spending zeal has been justified by summer floods and other emergency needs but that’s not the whole story
- Due to the government composition the number of government employees increased by at least 10%; the exact figure will be known later.
- Privatization, although almost completed with few remaining monopolies (gas, power and tobacco), has been virtually stopped: some privatization deals of the previous government (a power station, ports and airports on the sea coast, harboring the bulk of the charter traffic) have ended up in the courts and there is no clear message how the government intends to handle the entire issue. It is likely that the power station in the Black Sea port of Varna will be sold to Russian RAO Energy.

³ See below the paragraph on the talks with IMF.

- Lack of liberalization in the production and international and internal trade of electricity created a conflict with already privatized electricity distribution stations. It has been resolved by increasing the price of industrial consumers by 16% while prices for households remained unchanged. The ancient public heating system, centralized in a Soviet manner in 1950's, has been a joke for years. Lifting its subsidies has been postponed by previous government and had to be implemented by the incumbents.
- Big government deals like granting EURO 740 million highway concession on a non-competitive basis and building a second nuclear power station were nominally put on hold but, in fact, the government relies on the society's ability to forget, in the first case, while it is stubbornly working on the nuclear deal, which will cost EURO 2.1 million.

In this situation it was almost a miracle that the finance minister managed to compile and submit on time, few hours before the deadline,⁴ the 2006 budget before the legislature. The fiscal outlook is the following:

- The budget is balanced, although IMF insisted on a planned surplus of about 1.5% of GDP. The envisaged important parameters are: economic growth is 5.5% of GDP, annual inflation – 5.8%, the exchange rate to the dollar is BGN 1.61, and petrol price is 61.4 per barrel.
- There is a plan for less revenue from direct taxation. The lower tax threshold has been lifted from 10% to 20%, while upper threshold is 25%. All excise duties are to be lifted to the minimum EU level from January 1, 2006. The idea is allow the inflation to hit next year and secure the prospect to join the EMU by the end of 2009. The provisional tax burden will be increased by 0.6-0.7% of GDP in absolute terms.
- One of the reasons for this situation is the idea to finance state pensions with tax revenues. Social welfare taxes have been lowered by 6% (from as high as 41.5%), due to decreased employers' pension contributions but the pay-as-you-go system remains unreformed – the system's expenditures will be financed by other tax

revenues and quasi-fiscal government income (25% of privatization proceeds and 50% of the money saved through improving administrative efficiency). The expected figures are not named at all but the budget law prohibits line ministers spending excess revenues (thus hinting that currently there is a problem of overspending).

- Eventually, the social welfare (pensions and mandated labor and other benefits) will consume 18.5% of GDP. The next most money wasting sectors – public healthcare and education – remain unreformed and fiscally tolerated against private alternatives.

IMF talks

There is a serious risk that the stand-by agreement would not be reconfirmed. There two key disagreements.

- The first is the spending pace in the recent months. The situation is basically very simple. The first move of the finance minister, Mr. Oresharski, was to push for an amendment of the budget compilation law that requires budget surplus above 1.5% of GDP to be spent upon parliamentary approval. Legislators voted the amendment promptly but the spending ministers acted faster.
- The second issue is more complicated. IMF is worried by the fact that the current account deficit grew unexpectedly from 7.6 to 13.3% of GDP. If investment ceases coming in from abroad there is a probability of an external shock, argued IMF. Given the failure of central bank administrative measures to cool down credit growth (of roughly 30% per annum)⁵, IMF did not find any other instrument at hand besides pressing a fiscal break, i.e. keeping taxes high and refrain from spending. The government was not very open what argument they used in the talks, but obviously it insisted on not cutting the expenditures and referred to the common practice of combined current account and (sizable) fiscal deficits in EU, including 2004 members before accession.

⁴ By law, the deadline is October 31.

⁵ IMF interpreted the widening of the current account deficit as stemming from consumer credit expansion, and these very policies (raising minimum reserve requirement, application of credits ceilings) were inspired by IMF and implemented by central bank in the first quarter of 2005.

The Bulgarian economist community (besides few exceptions) expressed the following arguments against IMF views:

1. imports are due to investment and embrace mostly investment goods (a process that is natural given the record high FDI of over EURO 2 billion in 2004); export grows, fiscal reserves have double the amount need, credit expansion, although unexpected, does not signal accumulation of non-performing loans and if there signs of risky behavior the central bank should punish the wrong-doers;
2. the fiscal constellation with huge surpluses is more risky for the current account deficit because the spending pattern of the left-minded government is to finance consumption of non-productive populace after taxing productive folks;
3. if Bulgaria is to enter EU in 2007, the external balance would become somewhat artificial macroeconomic indicator; there is little provided there is no theory to advice what kind (what amount) of surplus could cure the current account problem but it is likely that taxes could discourage savings and encourage evasion (which is anyway twice the EU average), and, lastly, the hope is that Bulgaria would continue to attract foreign saving as it was the case with new EU entrants.

I think that the current constellation is due to historic factors (delayed consumption and investment, late bank reforms, and generous welfare state) that are hardly manageable by any of the policies discussed. A provisional healthy policy mix could include simultaneous reforms in pensions and healthcare to provide for individual accounts and savings, lowering government expenditures and direct taxes (while keeping the level of indirect ones), accountable public procurement and information sharing between banks. Unfortunately, none of these is entirely in the IMF policy arsenal (of a stand-by agreement) and government is reluctant even to think in this direction. The incapacity is, to extend, due to the long cooperation with IMF; its role in Bulgaria was fairly positive but diminished the ability of Bulgarian establishment to think on its own.

EU prospects

On October 25 the European Commission presented its Bulgaria 2005 Comprehensive Monitoring Report. The key points of the report are relative well-known, I would comment only

on the prospect to meet EU requirement in due time, i.e. by early spring next year. The most difficult issues to resolve are the following:

1. ***Organized crime.*** The issue is really serious one, not so much because of the size of the black economy but because of the uncertainty it nourishes. The roots of Bulgaria problems are in: a) the ineffective prosecution, which plays its own independent game, not reporting to anyone and protected by immunity; b) the immunity itself is broadly defined and widely applied (to all magistrates, top public servant and members of parliament); c) there was little or ineffective (those fired started “businesses”) cleaning up of the ex-communist structures of the ministry of interior, limited or no publicity of their operations, and all attempts to open archives of the Bulgarian analogues of KGB were blocked, including form the previous government; and d) there is little coordination and much competition between different law enforcement bodies, the basic level of skills is very low, and for fifteen years of reforms there was only one minister who fit the task. All these are impossible to resolve in a year or so. The incumbent minister is far from capable of making a difference. On the top of all these – there is no “EU model” to follow. What will be done? The parliament already voted the penal procedure code where most EU requirements are implemented on paper. The government has drafted a constitutional amendment to lift the immunity. Since there is no universal standard, the cabinet is trying to demonstrate successes in fighting crime. Those would be difficult to prove.
2. Related to the above point is ***corruption.*** Its impact on the local economy is most probably bigger than black (organized crime) market. The problem is that for year the lack of accountability has been used to finance political parties, i.e. the very Bulgarian democracy. Political leaders have shown no will and personal example to deal with the issue; the previous government even stated its mandate with a session on how to avoid the requirement of the public procurement law. Foreign governments and EU itself eagerly financed expensive anti-corruption fighting project thus crowding out grass-root efforts to finds answers to simple questions, like: “who got that public procurement auction and why”, “how much

the government costs”, “why customs do not function” and the like. Last but not least, small fishes were sometimes persecuted but not the big ones. The government will try to demonstrate resolve and boldness on this front and it is likely that it will manage to improve its accountability and publicity. Otherwise, it will become unmanageable. Part of the problem is linked to the fact that there are two types of inefficiency built one onto another, the EU and Bulgaria one. It seems that it will take time to reconcile those and the country will not use the subsidies that are made available for the pre-and-post-accession period.

3. In this regard, there number of technical issues (CAP related filing and statistics, sanitary and environmental controls, copy-right databases and enforcement), which will be fulfilled on time but with a

significant delay in the *administrative and provisional beneficiaries’ capacity to utilize subsidies*.

It seems that Bulgaria will join EU in 2007, resembling Greece at the day of accession with less cash available from Brussels.

Instead of conclusion

At the end of October I stroke 50, and a friend from Britain made me a valuable present – a book by Frank Fox title “Bulgaria” and published in London by A. & C. Black Ltd 90 years ago, on the aftermath of the Balkan wars and the first year of World War One. The last sentence of that book is very epilogue for the end of 2005: “Simple, laborious, religious, frugal, they [Bulgarian peasants] deserve better than to be food for powder” (*Frank Fox, Bulgaria, London, A. & C. Black Ltd, 1915, p.206.*).

Plan B – Effects of the Eventual Delay of Bulgaria’s Joining the EU⁶

Georgi Angelov, Svetla Kostadinova, Dimitar Chobanov

Accession treaty art. (39):

*If, on the basis of the Commission's continuous monitoring of commitments undertaken by Bulgaria and Romania in the context of the accession negotiations and in particular the Commission's monitoring reports, there is clear evidence that the state of preparations for adoption and implementation of the *acquis* in Bulgaria or Romania is such that there is a serious risk of either of those States being manifestly unprepared to meet the requirements of membership by the date of accession of 1 January 2007 in a number of important areas, the Council may, acting unanimously on the basis of a Commission recommendation, decide that the date of accession of that State is postponed by one year to 1 January 2008.*

The European Union as a reform stimulator

Most of the economic reforms in Bulgaria have been made not because of the inner confidence

of the people who carried them out, but due to the outer pressure mainly from international financial institutions such as the International Monetary Fund and the World Bank. Their basic medium of forcing the government to carry out reforms was the so crucial to the financial and macroeconomic stability of the country. However, as time has passed, the importance of the funding from international financial institutions began to decrease, and so did the ability of the IMF and the World Bank to provoke reforms in Bulgaria.

Gradually the EU took the place of the IMF and the World Bank as a reform stimulator, and part of the more recent reforms have been made under its pressure. The willingness of the Bulgarian people and politicians for Bulgaria to become member of EU, gave the EU the power to push the reform process. The problem is that the more certain Bulgaria’s EU membership becomes, the less influence on reforms the EU has. When a certain country becomes a member of the EU, the inner consensus necessary for the reforming process disappears, along with the purpose of the reforms –EU-accession.

Using the preventive clause, the EU tries to solve this problem, stimulating Bulgaria and Romania to continue their reforms. This clause keeps both countries in check and prevents them from thinking that they are already members of the EU and that there is no need to change any

⁶ The article is published for the first time in the “Policies” magazine of the “Open society” Institute - Sofia (<http://politiki.osf.bg>), issue. 24, 18.07.2005.

more. It turned out that the lack of inner confidence in the Bulgarian society, concerning the necessity of the reforms, should be compensated by outer pressure. In that case the preventive clause (especially if it urges forward the reforming process without coming into power) could have a good effect on the country. But it's coming into power will have both positive (reform stimulation) and negative effects such as the inability to profit by the advantages which an eventual EU membership would give and of course the risk of further postponement.

Free migration

Free movement of people inside the EU is one of the biggest advantages that EU membership can give to a country. Unfortunately, the economic problems in some European countries which are members of the EU led to restrictions in migration for new member countries from the former Soviet Union. Despite this, three of the old members (Ireland, Great Britain and Sweden) and two of the new ones (Malta and Cyprus) apply the free movement principle towards all member countries and will probably apply it towards Bulgaria after its EU accession.

Free movement of people ensures competition on the labor market, with all of its advantages. On a limited national labor market it is more possible that a shortage of certain types of labor occurs, with the resulting problems to the economy following it, compared to an opened

international labor market. Besides citizens of a certain country have the opportunity to gain know-how and experience in a foreign land and later apply it in their motherland (provided that a suitable business environment exists). Also important is the fact that part of the money earned by Bulgarian emigrants is a sizable and steadily increasing income for their families back home, forming national income bigger than the educational and the healthcare budget of the country.

Postponing the accession of Bulgaria to the EU will lead to a decrease in the opportunity for Bulgarian workers to work legally abroad in countries that do not hinder free migration. This means that many people will continue to work illegally abroad or will try to emigrate illegally, thus increasing expenses.

Not joining the EU will definitely have a negative impact on free people movement in Bulgaria. It will be cushioned by the fact that many countries do not admit workers from former Soviet Union countries to their labor market. The only adequate response politicians in Bulgaria could give to this situation is to create a business-friendly environment, thus stimulating the opening of well paid working places. This will, to a certain extent, reduce the negative effect of an EU-accession delay.

European funds

Expected funds after joining the EU:

Financial package 2007 – 2009

Mln. Euro (in 2004 prices)	2007	2008	2009
Structural reforms	539	759	1 002
Agricultural development	183	244	306
Provisional Instrument for facilitation of the cash flows and assistance of the Shengen agreement's realization	121.8	59.1	58.6
Nuclear energy safety ⁷	70	70	70
Total	804.8	1 132.1	1 436.6

Source: Bulgaria and Romania accession treaty; Report on the results of Bulgaria and Romania accession negotiations.

Bulgaria's payments

⁷ During the period between 2007 - 2009 the EU grants Bulgaria financial help, supporting the country's efforts to put out of operation and undertake measures to overcome the consequences of shutting down the nuclear reactors 1 to 4 of the "Kozlodui" nuclear power-plant.

- 1) Since the date of their accession Bulgaria and Romania pay the following sums, according to their share capital, carried in for the registered capital, defined in art. (4) from the By-laws of the European Investment Bank ⁸.

Bulgaria	EUR	14 800 000
Romania	EUR	42 300 000

These sums are paid in eight equal installments maturing on 31.05.2007, 31.05.2008, 31.05.2009, 30.11.2009, 31.05.2010, 30.11.2010, 31.05.2011 and 30.11.2011.

- 2) Payment for the EU budget – 1.24% of GDP.

Utilization of European funds

Disadvantages:

- Lack of experience and preparation for using the EU funds – most probably in the first years the money for agricultural development will be inefficiently spent (for creating governing administrative structures for example and not for helping growers)
- Change in motive of entrepreneurs – they are attracted to the funded business spheres, not because of the opportunity to do business more cheaply, but only to take advantage of the funds.
- The increase in government administration, needed for assimilating funds, will lead to an increase in government spending and in corruption risk.
- One of the basic requirements for receiving EU funds is co-financing from the state budget (at least 25%). On the one hand, this means that part of the taxpayers' money will be spent on financing different society groups. On the other hand, according to Ministry of Finance data, it is apparent that despite the increase in assimilation percentage EU funds are not completely utilized.

Financial assimilation of pre-accession programs

⁸ The mentioned figures are indicative and are based on 2003 data, published by Eurostat.

	ISPA	SAPARD	RHARE 2003
May 2004	16.41%	16.29%	18.51%
December 2004	29.13%	40.95%	56.29%
May 2005	41.12%	n.a	62.58%

Source:

Ministry of finance, financial assimilation of pre-accession programs, selected periods

Advantages:

- The eventual introduction and use of new technologies will increase productivity of labor, which is lower than the EU average, especially in agriculture.

As a conclusion, we can summarize – the expected EU funding for the year 2007, which comes up to 804.8 mln. EUR (1573.6 mln. BGN), will be spent on different society groups. If we take the 2004 state budget over fulfillment data into consideration (1500 mln. BGN), we can expect that in 2005 it will be at least 1000-1500 mln. BGN. In that case, it is completely possible that Bulgaria could continue its reforms without European funding. In order for the country to sustain its rate of economic growth it is necessary (and feasible) that the overall tax burden would be reduced. Thus the effect will be enhanced, no unnecessary expenses and increase in government administration will be made, entrepreneurship and employment will be stimulated.

Trade

Free movement of goods, as far as it is not hindered as migration, is an extremely important advantage following from the EU membership. It eliminates possible monopolies on the domestic market already existing in Bulgaria, due to import limitations on certain commodities. At the same time, it eases the export of domestic products, most of all agricultural ones, which are currently not freely traded. From this point of view, the eventual delay of Bulgaria's EU accession will slow down the process of integration of the country's economy to the world economy and will result in an inability to fully take advantage of labor division.

Investment

Postponement of the EU accession is the topic considered to be fundamental before the general elections in Bulgaria. It is presented only as harmful to the economy, considering the benefits from joining the EU. But there are certain negative effects of the EU membership, which should also be taken into consideration.

The accession to the EU means that the harmonization between Bulgarian and European legislation is complete and some regulations that are not necessarily good for the business are approved. During the process of integration, part of the legislation was adopted without evaluating its effect on Bulgarian companies. The principle in the EU when proposing new regulations or altering old ones, is to evaluate their effect by making a cost-benefit analysis. Thus the new regulation is approved only if the benefits exceed the costs. The Bulgarian government however did not respect this principle, because it hurried to close the negotiation chapters (claiming the political benefits from it), ignoring the fact that the acquiring of its short-term aim might be in contradiction with the interests of many Bulgarian firms and citizens.

Thus, many impediments for the domestic companies are created, because they are compelled to obey certain standards before the country joins the EU. This would provoke particularly large expenses for the small- and medium-sized enterprises and may cause their bankruptcy. A one-year delay of the EU membership could give them enough time to prepare and avoid bankruptcy. Some of them however won't be able to persist, even under these conditions, because the investment needed is too large to fund. Therefore the postponement will keep them artificially on the market for one more year, preventing them from relocating their resources into more profitable areas i.e. we can expect negative impact on economic efficiency as a result of the delay.

The net effect from the two opposite actions can hardly be measured, but what we can expect is the crash of some companies, reduction of employment and income of the people who work there. On the other hand, the firms which survive will have better access to European and international markets. They will have the opportunity to export most of their production and increase profits.

Another aspect of the preventive clause is its impact on investment in the country. Investment is to a great extent influenced by the elected government and by the policy it pursues during its mandate. The acceptance of Bulgaria in the EU is a powerful stimulant to investors and the essential fact is that whether in 2007 or 2008, Bulgaria will become a member. Nevertheless, the investors will consider the postponement a bad sign. It is crucial that the necessary reforms in administration and the judiciary system are undertaken in order to reduce corruption, which is considered to be the main barrier for investment. Also important is the improvement in protecting private property, which guarantees risk-takers reward for their efforts.

Bulgaria could compensate the eventual negative effect, by improving the rest of the factors influencing over investment. One of these factors is taxation, and a lot can be done to reduce the tax-welfare burden. But failing in changing that, may lead to a further fall behind of Bulgaria, in compare to its competitors, which are already in the EU, namely Estonia, Lithuania and Slovakia.

Another possible unfavorable effect on incoming cash flow in 2007 could be the eventual raise of interest rates by the European Central Bank. Currently they are at a very low level, which makes investment in EU countries unprofitable. Therefore, part of the investments are re-directed to countries like Bulgaria. If the ECB raises the interest rates, combined with the eventual coming into power of the preventive clause and the slowing down of the privatization process, this may lead to a decrease in foreign investment. In general, this will affect the country's rate of economic growth and the opening of new working places.

Adoption of the European currency

The postponement of Bulgaria's EU-membership will have a direct effect on the adoption of the euro as a legal means of exchange (eurozation) in the Bulgarian economy. The eurozation has several positive effects. One of them is the abolition of the insurance premium on European and Bulgarian currency deposits. This premium consists of lower interest rates on credits, granted by credit institutions, when denominating EUR to BGN, which raises the expenses for funding Bulgarian currency. Besides, the adoption of the Euro will

reduce the possibility of a currency or a bank crisis. The Euro is a powerful stimulant to trade and tourism within the limits of the EU, significantly reducing transaction costs and provides the ability to easier compare prices of goods and services in the Euro zone.

EU-membership and compliance with the Exchange Rate Mechanism 2 are indispensable conditions for adopting the Euro. According to the ERM 2 several criteria must be fulfilled. Some of them (budget deficit, government debt, exchange rate and yield of government securities) are already achieved, but the main challenge remains inflation. Inflation must be kept under 3.5% for two successive years (2007 and 2008), which is hardly feasible, considering its rate after the currency board was brought in.

Therefore, delaying Bulgaria's EU accession will inflict many losses in this direction.

Instead of a conclusion

Generally, the delay of Bulgaria's accession to the EU would have a mixed impact on the economy. However, the country's economic development depends chiefly on the internal economic policy. No matter when Bulgaria actually joins the EU the economic results achieved by the country's economy (good or bad) are consequences solely from the policy of the government and are its responsibility. If the government is open enough to reforms, there will be no reason for us to expect postponement of Bulgaria's EU-membership, and even if that happens it won't cause much trouble. If not, then substantial economic problems can be expected, independent from the year of accession.

7 June - The Day When Bulgarians Stopped Working for the Government

Adriana Mladenova, Veliko Dimitrov

According to calculations of the *Institute of Market Economics* this year the Bulgarian citizens stopped working for the government and begun working for themselves on **7 June 2005**. Taken figuratively, if the whole income of people was being used first to cover the annual government revenues, the government would take all earnings of every citizen till day 158 of the year or 7 June 2005 and only after this date people would begin working and earning for themselves. We have called this date *Government Freedom Day* by analogy with *Tax Freedom Date*, which is calculated by the Canadian *Fraser Institute* and American *Cato Institute*. By this imaginary exercise we aim to present the role of the government in the process of redistribution of income of the citizens.

The methodology of calculation of this peculiar Freedom Day is as follows: based on the forecast of GDP in Bulgaria for 2005 we calculate the average aggregate income per day earned by the Bulgarian economy. The average income per day amounts to 114 million leva. According to IME forecast, the government revenues in 2005 will pass 18 billion leva. Dividing the revenues by the average income per day we get the

number of days in which the citizens should work in order to earn the government revenues. The government coercively takes these resources from people and supplies public goods in return – state health services, education, etc.

Of course this is just a simplified and standardized example and for each person this day varies according to the level of income earned and the share of it that is being taken away through taxes, fees and other fiscal burdens. You can compute for each single person the exact day he or she stops working for the government and starts working for himself/herself and his/her family.

We have used the methodology described above to compare Bulgaria with other countries. Results are shown in the table below.

Table: Comparison with other countries*

Country	Real GDP growth (%)	Days working for government
Lithuania	7.0	122
Latvia	8.3	132
Estonia	7.8	137
Bulgaria	5.6	152
Germany	1.6	171
Italy	1.2	177
France	2.3	199

Sources: Eurostat; Ministry of Finance of The Republic of Bulgaria; own calculations

* Data for 2004

The correlation between the level of economic growth and number of days working for the government is obvious: the less time working for the government, the higher the economic growth. Reducing the share of redistribution by

authorities will result in higher disposable income for people, which will definitely lead to stronger incentives for them to work and rediscover the spirit of entrepreneurship that are the main engines of economic growth.

Economic Migration – European Practices⁹

Georgi Angelov

Very often when migration is mentioned the attitude is negative. In the countries that people leave the talk is of “melting of the nation” and “brain drain”. In the countries where people migrate, allegations emerge that immigrants increase levels of criminality, etc. In most cases, these allegations are groundless and cover internal problems of the respective country. It is always easier to accuse those who leave or those who arrive in the country for some problem than to make efforts to cope with its causes.

However, migration is rather a natural phenomenon than problem or unusual event. People have always migrated – from rural toward industrial regions, from villages to cities, from high unemployment to low unemployment places. When this migration is international there are more barriers for passing – in some countries there exist barriers for leaving the country, in most countries the barriers are against foreigners that settle down in the country.

Exit barriers are a trademark of unfree countries and they are perceived as inconsistent with the principles of the liberal democracies-this question is settled. Entry barriers are perceived as needed. However, what must be the type and design of these barriers is a highly debatable question, which is resolved in different ways and with different success in the individual countries.

The differences in migration policies between the individual countries in the EU and the candidate countries are the reason for the European Commission to organize discussion and exchange of experience on the issue. In this discussion the main role was given to the experience of Ireland, because in the recent years its market-oriented migration policy established as one of the leading practices in Europe.

What is the Irish migration policy?

The Irish policy on economic migration is based on the economic needs of the country, addressing deficits of labour resources and skills. The main characteristic of the policy is that it is based on the market signals and it doesn't depend on the evaluation and discretion of the administration. This makes the system extremely flexible and effective.

In respect to the EU member states Ireland does not apply any restrictions, i.e. every citizen of the 25 EU countries plus the countries from the European Economic Area can settle in Ireland and work there. The main tool of the Irish migration policy in respect to the countries outside the European Economic Area is the system of work permits.

The work permits system is based on the existence of job vacancies that cannot be filled from the European Economic Area. In order to prove the need for hiring a foreigner, the employers must advertise the vacancy with the National Employment and Training Agency and after one month passes without finding local candidates they can offer the job to a foreigner.

The work permits are issued to the employer for a specific employee and for a specific workplace. However, in most cases it is possible for an employee to change his workplace as the new employer receives a new work permit. In short, the basis of the Irish policy is that the market and the availability of job vacancies determine whether work permits will be issued for immigrants from the countries outside the European Economic Area, i.e., for people from within the area no permits are required.

As a result of the fast economic growth in Ireland, more comparatively high paid jobs are being created in recent years. Local people cannot fill them because there is no unemployment in the country already (see table). As a result for the last five years more than 150,000 people joined the labour market in the country. They contribute to the increase of the economic growth and rise of prosperity of

⁹ The article is published in “Capital” weekly, 29/July 2005

Ireland, which is already the second wealthiest country in the European Union (only Luxemburg ranks before Ireland). According to

some studies the inflow of emigrants increases the GDP growth by 3-4 percent per annum.

Ireland's Labour and Migratory Experience 1994 to 2004

	Labour Force	Employment	UE Rate	Inflows	Outflows	Net migration
	000s	000s	%	000s	000s	000s
1994	1431.6	1220.6	14.7	30.1	34.8	-4.7
1995	1459.2	1281.7	12.2	31.2	33.1	-1.9
1996	1507.5	1328.5	11.9	39.2	31.2	8
1997	1539	1379.9	10.3	44.5	25.3	19.2
1998	1620.4	1494	7.8	46	28.6	17.4
1999	1685.9	1589.1	5.7	48.9	31.5	17.4
2000	1745.9	1671.4	4.4	52.6	26.6	26
2001	1787	1721.9	3.6	59	26.2	32.8
2002	1840.9	1763.9	4.2	66.9	25.6	41.3
2003	1875.5	1793.4	4.4	50.5	20.7	29.8
2004	1920.3	1836.2	4.4	50.1	18.5	31.6

Source: Alan Barrett, *Ireland: Increasing Labour Supply through Immigration*, Economic and Social Research Institute, 2005

The experience of other countries

Bulgaria adopted by and large the Irish model in respect to the work permits. Here they are similarly issued by request of the employer if there are no Bulgarian citizens that can fill the job vacancy. The problem of Bulgaria is the high unemployment, the slow growth of labor demand and low wages that don't stimulate foreign citizens to work in the country. Therefore, Bulgaria must first become a rich country and only after that foreigners will be attracted here by economic reasons.

As far as our country is poor, the process of migration will be directed outward, toward emigration of Bulgarian citizens in more advanced countries. That is not necessarily a negative development, because through emigration these people receive many skills, which later on can be applied in Bulgaria (if appropriate conditions exist) and can support its development. The emigrants are also sending their relatives considerable resources, which is one large source of funds to the country.

Most of the countries of the European Union apply more regulated, administrative system for accepting economic migrants.

Austria accepts migrants on the basis of a quota, determined annually as a percentage of the labor potential of the country and the individual regions. The need for workers is assessed by the Austrian Institute of Economic Research.

Separately, the so-called "key workers" can receive work permits on the basis of a separate quota – that is a system for attracting highly educated people. In order to receive a permanent work permit the economic migrant in Austria must have five years of legal stay in the country (one year with an employment license and twice two years with an individual work permit). As a whole, the Austrian system is quite complicated, permits considerable administrative discretion and has many requirements. This is why the country cannot attract enough migrants, including the highly educated.

A similar system is applied in **Portugal**. The decision whether and how many migrants to be accepted in the country is taken by the administration on the basis of its estimate of the needs on the labor market. Then a corresponding annual quota is determined. In reality, however, if the shadow sector is included, the inflow of migrants is twice as big as the people granted work permits (mostly from former colonies and Eastern Europe). The system for limiting immigration does not work as intended because of the impossibility of its practical application.

The migration policy of **Cyprus** is most interesting. It is based entirely on the logic that workers receive *temporary* work permits. After the expiration of the permit the worker must leave. In distinction to the above-mentioned countries, there is no system in Cyprus that allows acquiring of permanent work permit and

settling in the country. As a result, most of the workers that migrate to the country are low skilled and less educated, working on a seasonal and not very well paid jobs.

Without illustrating more examples it seems that the market approach for attracting economic migration to Ireland shows the best results. Countries, applying more complicated,

restrictive, administrative and discretionary policies in this field cannot attract enough highly educated emigrants although they declare that as their goal. At the same time Ireland attracts considerable number of foreigners with high qualifications that contribute to its fast economic growth.

Bulgaria Moves Ahead

Yassen Halachliyski

Canada's Fraser Institute published lately his newest report Economic Freedom of the World. This is the 9th edition with data from 127 nations for 2003.

The first report, published in 1996, is the result of a decade of research by a team including several Nobel Laureates and over 60 other leading scholars in a broad range of fields.

Economic Freedom of the World measures the degree to which the policies and institutions of countries are supportive of economic freedom. The cornerstones of economic freedom are:

- Personal choice
- Voluntary exchange
- Freedom to compete
- Security of privately owned property.

Thirty-eight components and subcomponents are used to construct a summary index and to measure the degree of economic freedom in five areas:

- Size of government
- Legal structure and protection of property rights
- Access to sound money
- International exchange
- Regulation of credit market, labor market and private enterprise

Since its first edition the index has been demonstrating a clear rise of economic freedom for the world on average. Moreover nearly 90% of the nations recorded an improvement in their economic freedom score. This clearly demonstrates the growth of living standards.

According to the authors high degrees of economic freedom have other significant advantages:

- Higher GDP per capita
- Higher economic growth rate per capita
- Higher employment rate
- Longer life expectancy
- More political rights for the citizen

In this year's index, Hong Kong retains the highest rating for economic freedom, closely followed by Singapore, New Zealand, Switzerland, and the United States.

Bulgaria is in the middle of the ranking list. We share the 70th place with Nicaragua, Tanzania, Tunisia and Slovenia.

Although moving some places up Bulgaria still shows some negative developments. Examples are the flexibility of the labor market, the size of government, especially its consumption, transfers and subsidies.

Bulgaria falls behind with some reforms

Size of government (4.4) – social insurance remains the main problem, which has not changed for the last editions of the index. Government consumption, transfers and subsidies also suffer decline in their evaluation.

Legal Structure and Security of Property Rights (4.7) – Judicial Independence and Impartial Courts in Bulgaria receive the lowest evaluation among all the indicators of the index.

Regulation of labor market (5.0) – minimal wage and low flexibility of hiring and firing are the main problems.

Positive developments in Bulgaria

The development of the credit market (8.0) and the access to sound money receive the highest scores. This stems from the low inflation that is relatively stable over the years.

Another positive change is evident in the area of business regulations. Starting a new business has become slightly easier, government bureaucracy consumes now less time and irregular payments to government officials are lower. There is still much more to be done in this area.

Year	1990	1995	2000	2002	2003
Ranking	97	103	106	80	70
Size of Government	2.5	4.0	4.0	4.6	4.4
Government Consumption	4.9	6.5	5.2	5.7	5.4
Transfers and Subsidies	2.7	6.6	5.8	5.5	5.3
Government Enterprises and Investment	0.0	0.0	2.0	2.0	2.0
Top Marginal Tax Rate		3.0	3.0	5.0	5.0
Legal Structure and Security of Property Rights	7.2	5.9	5.4	4.7	4.7
Judicial Independence			4.2	2.8	2.8
Impartial Courts		5.3	4.5	2.7	2.7
Protection of Intellectual Property			3.4	2.8	3.0
Military Interference		7.5	8.3	8.3	8.3
Integrity of Legal System		7.0	6.7	6.7	6.7
Access to Sound Money	4.4	2.0	3.2	8.2	8.8
Growth of Money Supply	7.4	3.0	0.0	7.2	7.2
Inflation Variability	5.6	0.0	0.0	6.6	8.6
Recent Annual Inflation	4.8	0.0	7.9	8.8	9.6
Freedom to Own Foreign Currency	0.0	5.0	5.0	10	10
Freedom to Exchange with Foreigners	4.3	6.9	7.3	6.8	7.3
Taxes on International Trade	8.4	6.4	7.8	7.5	7.4
Regulatory Trade Barriers			6.4	6.4	6.4
Size of Trade Sector	4.8	5.9	7.1	6.6	6.8
Official versus Black Market Exchange Rate	0.0	9.0	10	10	10
Restrictions on Capital Markets	0.0	5.0	5.0	3.7	6.0
Regulation of Credit, Labor and Business	3.0	4.3	5.4	5.8	6.0
Regulation of Credit Markets	1.7	4.3	5.9	7.9	8.1
Private Ownership of Banks	0.0	2.0	8.0	8.0	8.0
Competition from Foreign Banks			5.2	9.0	9.0
Extension of Credit to Private Sector	1.0	3.0	7.1	7.3	8.2
Avoidance of Negative Real Interest Rates	4.0	8.0	4.0	10	10
Controls on Interest Rates			5.3	5.3	5.3
Regulation of Labor Markets			4.9	5.1	5.0
Impact of Minimum Wage			2.6	2.6	2.6
Flexibility in Hiring and Firing			4.3	4.6	5.0
Collective Bargaining			7.9	7.8	7.8
Incentives from Unemployment Benefits			6.8	6.8	6.8
Military Conscription	0.0	1.0	3.0	3.0	3.0
Regulation of Business			5.4	4.3	4.7
Price Controls	0.0	4.0	6.0	6.0	6.0
Administrative Obstacles for New Businesses			6.1	2.5	2.8
Time Spent with Government Bureaucracy			6.0	4.0	4.8
Ease of Starting a New Business			2.5	2.2	2.5
Irregular Payments to Government Officials			6.6	6.8	7.5

Forthcoming: IME Alternative Budget

The Institute for Market Economics is preparing its regular *Alternative 2006 Government Budget* with low taxes. It will be released on November 15, 2005 on a press conference in Sofia and will be published in a special issue of the IME's Flat Tax Bulletin.

Dear Readers of IME materials,

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